

# SMK

## UNDERSTANDING HEDGING

Why it exists | the philosophy behind it | and how commodity hedging works in practice

**A strategic risk-management view for treasury, procurement and management teams**

(Part 1)

SMK SERVICES

Professional treasury advisory focused on governance, risk visibility and structured decision-making.

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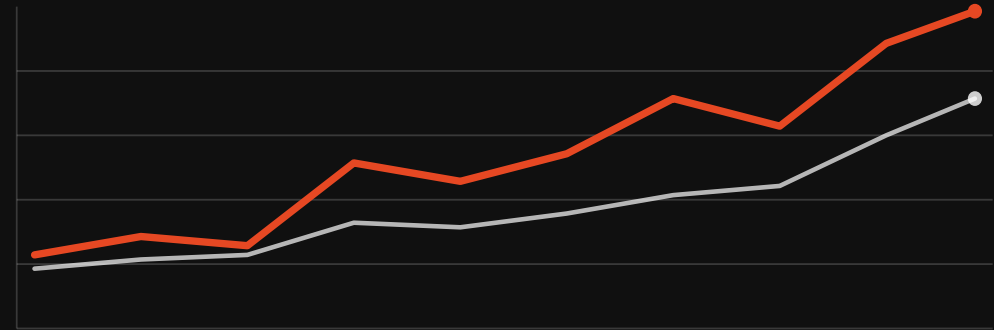
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# What hedging is

**DEFINITION**

**Hedging is a risk-management action used to reduce the impact of adverse price moves on the business.**

- It does not eliminate commercial risk.
- It aims to make outcomes more predictable.
- It is about protecting margins, budgets and cash flow.



**WITHOUT HEDGE**

High earnings and cash-flow volatility

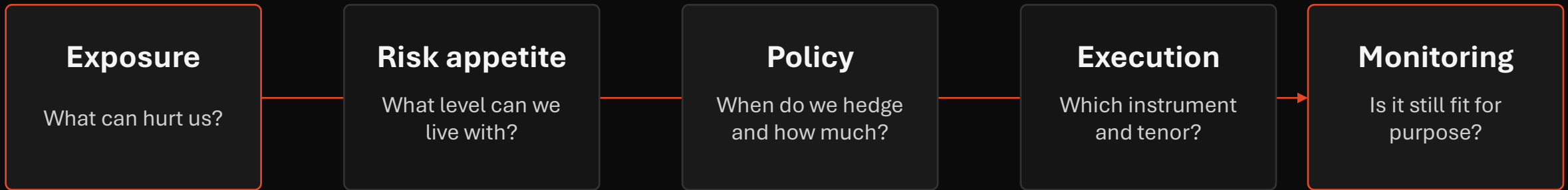
**WITH HEDGE**

More stable, budgetable exposure profile

*A hedge is not a bet on being right. It is a decision to reduce the cost of being wrong.*

# The philosophy behind hedging

**Hedging works best when it is one component of a wider commercial and treasury strategy — not a stand-alone trading activity.**



- The purpose is resilience: fewer earnings surprises, fewer budget shocks, fewer emergency decisions.
- The hedge must match the economics of the exposure: volume, timing, basis and tolerance for cash volatility.
- Good hedging disciplines management; bad hedging creates a second risk problem.

# Commodity hedging in general

Commodity hedging protects businesses whose costs, revenues or inventory values depend materially on market prices.

## The main buckets

### Energy

Crude oil, refined fuels, gas, power

### Softs

Coffee, sugar, cocoa, cotton, grains

### Metals

Gold, copper, aluminum, steel inputs

### Freight & adjacent

Shipping, logistics, procurement-linked exposures

## TYPICAL OBJECTIVES

- Protect procurement budgets
- Defend gross margins
- Stabilize pricing to customers
- Reduce inventory revaluation shocks
- Support financing and covenant predictability

# Oil hedging in today's context

## Why oil matters far beyond oil itself

- Crude and refined products feed directly into retail pump prices.
- Higher fuel costs then spread into freight, distribution and operating costs.
- Jet fuel pressure can move quickly into airline economics and, with a lag, ticket pricing.

### PASS-THROUGH LOGIC

#### Oil shock

Crude / product rally  
volatility & supply anxiety

#### Pump prices

Consumers and fleets feel higher fuel bills

#### Air travel

Airlines reassess fares, routes, capacity

*The current environment is a reminder that energy risk can hit households, logistics chains and travel costs almost at the same time.*

# Why hedging oil is challenging

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## Benchmark mismatch

A company may buy one product locally, but the available hedge references Brent, WTI, gasoil, jet or another benchmark. Basis risk remains.

## Volume uncertainty

Actual consumption can change with sales, weather, operations, fleet usage or travel activity. Over-hedging can hurt as much as under-hedging.

## Timing mismatch

The business buys in one period, pays in another, and reprices customers in another. Hedge timing must mirror real economics.

## Liquidity & governance

Some tenors are more liquid than others, collateral may matter, and management must understand mark-to-market swings before entering structures.

**Oil can be hedgeable — but only if the structure follows the business exposure, not the other way round.**

# Hedging soft commodities

## Typical softs

- Coffee
- Sugar
- Cocoa
- Cotton & grains

## Why companies hedge them

- To protect raw-material budgets
- To reduce margin compression
- To price sales with more confidence

**Softs hedging usually sits at the intersection of market price, physical availability and seasonality.**

That means the hedge conversation is often as much about procurement discipline and supply-chain timing as it is about derivatives.

*In softs, the commercial reality of crop cycles matters just as much as the screen price.*

# Why hedging softs is challenging

## Weather & crop cycles

Yields, quality and harvest timing can move abruptly because of rainfall, drought, pests or disease.

## Quality & grade differences

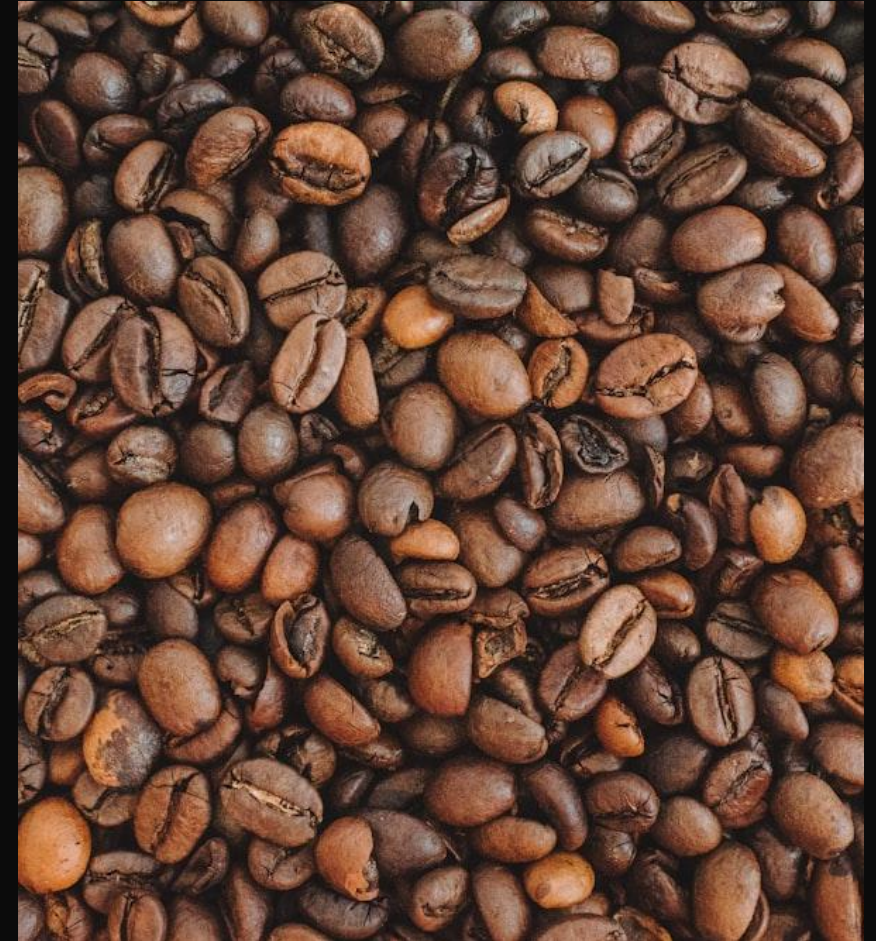
The futures or OTC reference may not match the exact quality the buyer consumes.

## Fragmented physical chain

Local premia, freight, warehousing and supplier terms can change independently of the headline benchmark.

## Limited internal data

Many businesses know what they buy, but not always the precise exposure profile by month, grade or supplier.



**Softs hedging often fails not because markets cannot be hedged, but because the exposure has not been defined precisely enough.**

# Hedging other products

The same logic extends beyond oil and softs whenever a business has a clearly identifiable price exposure.

## Metals

- Gold, silver, copper, aluminum
- Used by manufacturers, jewelers, processors
- Key issue: benchmark vs physical spec

## Energy-linked inputs

- Gas, power, LPG, fuel oil, jet, gasoil
- Important for utilities, transport and industry
- Key issue: shape, tenor and local basis

## Procurement-adjacent risks

- Freight, shipping-linked costs, inventory exposures
- Sometimes managed with commercial clauses, not only derivatives
- Key issue: turning cost drivers into a hedgeable map

# What good hedging looks like

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- Start with the exposure, not with the instrument.
- Set objectives clearly: budget protection, margin defense, or cash-flow stability.
- Choose the reference, tenor and volume to match the economics of the business.
- Accept that some basis risk may remain; document it.
- Build governance before execution: policy, approvals, reporting and monitoring.
- Review the hedge program as markets and commercial volumes evolve.

**Hedging is not about predicting the market perfectly. It is about making the business less vulnerable when the market is wrong for you.**

## SMK SERVICES

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Treasury thinking applied to real commercial exposures.

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